



# Banxico's monetary policy decision

## A tad less hawkish

August 2, 2018

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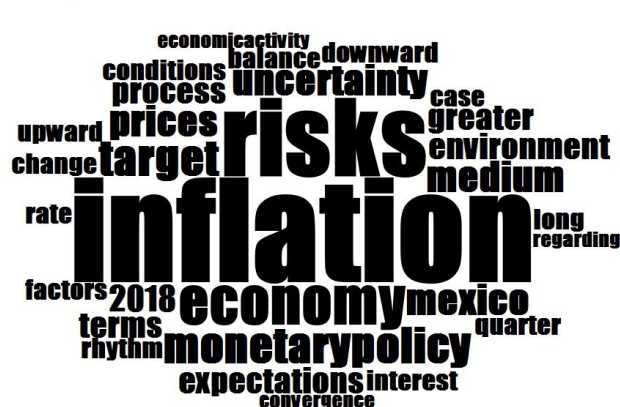
- Banxico's board announced today its unanimous decision to hold the reference rate at 7.75%
- In our opinion, the statement signals that the monetary authority is still considering the possibility of hiking the reference rate, although it would seem that for the time being it is not necessary as the risks are contained
- In this context, we maintain our expectation that Banxico will remain on hold over a period of 18 months
- Our view is based on our expectation that the current pick up in inflation is temporary –with inflation converging to 4.3% at the end of the year-, and that the exchange rate will continue to show a favorable performance, closing at USD/MXN18.6 by year-end (see charts on the next page)
- Nonetheless, we consider that our estimate entails significant risks that could lead to a rise in rates before the proposed horizon:
  - (1) There is a risk that Banxico will not be able to decouple from the US Fed, which maintains a hawkish bias and is expected to hike the *Fed funds* rate twice more in 2018, being the next one at its meeting on September 26<sup>th</sup>;
  - (2) Additional negative inflation surprises, as it has been the case in 4 of the last 5 CPI reports, which could continue to impact short-term inflation expectations; and
  - (3) Renewed currency pressures on the back of heightened geopolitical risks, among them protectionist measures of Trump's administration, and in particular, the renegotiation of NAFTA
- The linguistic analysis of the statement reinforces our view, highlighting a lower weight in the words "risks" and "uncertainty" vs. the previous statement, alluding to changes in the economic environment

August 2, 2018 Statement Word Cloud



Source Banorte

June 21, 2018 Statement Word Cloud

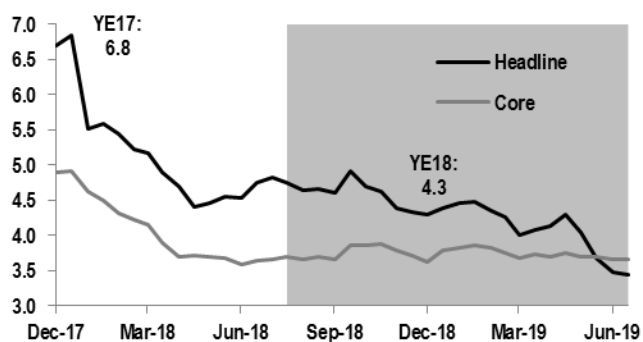


Source Banorte

- As it has been the case in recent press releases, the monetary authority did not change the order of the main factors to which it will remain vigilant looking ahead:
  - (1) Potential pass-through from exchange rate variations: Considering the 9% appreciation of the MXN since Banxico's last decision, we believe that the probability of contagion to prices has decreased, although Banxico continue to consider that there is an upward risk associated with "...higher external interest rates and U.S. dollar strength, and to persisting uncertainty in both the external and domestic fronts, among which the NAFTA renegotiation stands out...";
  - (2) Relative monetary stance between Mexico and the US: They still expect the US Fed to continue with its normalization process; and
  - (3) The slack in the economy: According to recent data for 2Q18, Banxico considers that slack conditions "...have loosened, while in 2018 GDP growth is anticipated to fall to the lower half of the estimated range (2 to 3%) and, therefore, [...]will continue to loosen.... "
- Regarding the balance of risks, the board of governors highlighted the uncertainty around the scenario, so that the balance for economic activity remains biased to the downside. In fact, they considered that GDP growth in 2018 will be in the lower part of the range estimated in their last *Inflation Report* (2-3%), as we had already mentioned
- In terms of inflation, Banxico shows a more cautious stance, recognizing that recent changes in relative prices "...affect the expected trajectory for headline inflation for the next twelve months, although its effects are estimated to be transitory..."
- All in all, Banxico seems more worried about an slowdown in economic activity than with upward risks for inflation, although the scenario still has some relevant uncertainties, mainly related to the renegotiation of NAFTA. However, we believe NAFTA will be resolved favorably but timing remains a risk in terms of potential market turmoil

### Inflation forecast

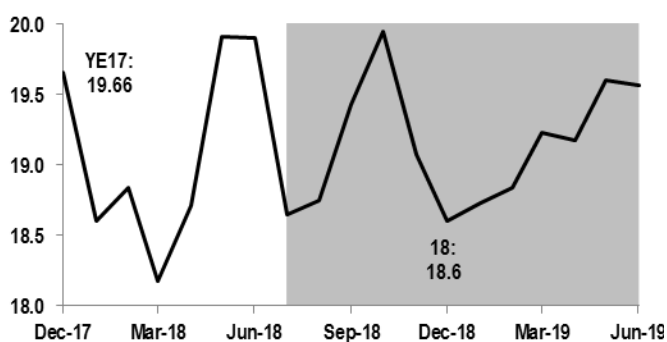
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Source INEGI; Banorte

### FX forecast

USD/MXN



Source Bloomberg; Banorte



*From our fixed-income and FX strategy team*

- In line with our view and market pricing, Banxico stood pat today (i.e. reference rate unchanged at 7.75%), but stressing out several risks for the inflation backdrop going forward. The concerns about current CPI dynamics and soaring inflation expectations were momentarily balanced by the strong performance of the Mexican peso since its last meeting (an 8.4% rally) and weaker economic data
- The hawkish tilt remained inside the policy *communiqué*, but with less severity than market expectations. In our view, one of the most significant threats for the central bank's current stance come from the high likelihood of more restrictive monetary conditions in the U.S. in the remainder of 2018
- In this regard, the market is likely to modestly price-in one additional 25bps implied rate hike and lower the odds for rate cuts in 2019. The current spread between ex-ante real repo rates in both countries is located at 475bps and suggests a 75bps buffer for Banxico, decreasing the room for significant rate cuts next year. Overall, local rates rallied following the policy announcement, mainly the front end of the yield curve (-9bps)
- The Mexican peso weakened after the report, from about 18.60 per dollar to a maximum of 18.69 and stabilizing around 18.65 for a 0.3% loss today. In our view, the less hawkish tone supports our neutral directional stance but long USD/MXN bias, waiting for a better entry level to open new positions
- We remain on the sidelines in the very short term as positive momentum for the peso has strengthened because of NAFTA negotiations. Nevertheless, with this guidance from Banxico and our base-case that a deal will not be reached this quarter, we see increased attractiveness of starting dollar longs below 18.50 in spite of the risk of a push towards 18.00 if an agreement is reached in August

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